

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
ENVIRONMENTAL FINANCIAL ADVISORY BOARD

August 4, 1998

Mr. William A. Nitze
Assistant Administrator for
International Activities
U.S. Environmental Protection Agency
401 M Street, SW (Mail Code: 2610R)
Washington, D.C. 20460

Dear Mr. Nitze:

I am writing regarding your request for the Board to review your office's draft proposal to set up an "Environmental Bond Guaranty Program" in the Newly Independent States (NIS) of the former Soviet Union. In response to your request, the Board discussed the draft proposal at its winter meeting, formed an ad hoc workgroup to review the proposal in detail, and held a public meeting to exchange views and gather comment on it from a diverse range of public and private sector experts. This letter integrates comments gathered from Board members and other parties during this process and provides you with the thoughts of the ad hoc workgroup.

General Comments

First, I want to say that the "Environmental Bond Guaranty Program" as proposed is an exciting idea that has the real potential to be of great benefit to the NIS countries. The proposal creatively uses a variant of a well established U.S. financing tool to leverage solutions to environmental, economic, and institutional challenges. The great majority of those with whom we discussed the draft proposal shared these views. You and your office deserve to be highly commended for this idea. Within this general context, the specific comments that follow are directed toward improving the final proposal that your office is developing to help ensure its ultimate success. These specific comments touch on five major areas: policy considerations, funding issues, environmental needs, legal concerns, and technical assistance.

Specific Comments

Policy Considerations

We believe that the proposal needs to better explain how the Environmental Bond Guaranty Program (EBGP) is in the national interest supporting U.S. government policy goals. As a complement to this, your office should consider a public information approach laying out the need for the program and seeking to involve those groups (environmental and otherwise) whose support is vital. Ideas already in the draft report concerning strengthening legal and administrative institutions to create greater cultural and government stability could be built on to enhance the policy benefit discussion. We need more in-depth information on the state

of public administration within the NIS, notably taxation and revenue, as a means of analyzing the risk of default. This should include emphasis on institution building in the NIS that would not otherwise occur. This approach will need to clearly demonstrate that the program is structured in such a way that limits economic and political liability to the U.S. government.

Funding Issues

The draft proposal envisions an EGBP capitalized in the amount of \$100 million. As an operational matter, the program will not function effectively, if at all, without the minimum \$100 million funding. Ideally, the full funding would be available at program start up. The draft achieves this via a \$50 million appropriation in Fiscal Year (FY) 1999 and a \$50 million appropriation in FY 2000. We think that unfortunately either of these funding patterns may be difficult to achieve. You may want to consider allowing for a third option in the form of \$35 million in FY 1999, \$35 million in FY 2000, and \$30 million in FY 2001. We recognize this would reduce the leveraging projections in your draft proposal.

Another approach would be to seek funding from other public or private partners such as the World Bank or the private bond insurance industry. It would be worthwhile to explore possible formulas for paying back private investment in such a fund. We also believe the final proposal should price out not just the capitalization cost, but also EGBP administration costs and especially complementary technical assistance costs. Finally, in regard to funding and measurement of program effectiveness, we feel it will be important to emphasize the long term nature of the program and its ability to grow over time. Regardless of the long term administrative control structure, the financial and environmental benefits of this program cannot be measured in one or two year increments, but rather over ten or twenty years.

Environmental Needs

The draft proposal makes a good beginning regarding the types of environmental projects that will be eligible, but does not address what environmental criteria will be used to select projects. For example, the EGBP could require that projects meet international standards used by the World Bank or the European Bank for Reconstruction and Development. Alternatively, the EGBP could require that they meet certain U.S. standards, use appropriate technologies, or just simply demonstrate due diligence.

Legal Concerns

While NIS laws and institutions may be adequate for existing programs, the EGBP is a new concept and must be carefully implemented. The EGBP should retain at the earliest possible moment expert in-country legal and financial counsel for each country and region within which it operates. Expert counsel is a legitimate expense that will consume a significant portion of the general and administrative costs associated with the program. The structure and terms of the program's guaranty should be as clear and simple as possible. Enforcement of the guaranty will be crucial and should be determined early on in close cooperation with the appropriate national and regional governments. The EGBP will also need the legal and political expertise necessary to deal with the sensitive issue of corruption.

Technical Assistance

A common theme raised by the wide range of parties participating in the many discussions undertaken by the ad hoc workgroup was the importance of technical assistance (TA). In fact, many parties stated that TA was absolutely essential to the ultimate success of the proposed EGBP and indicated it was not adequately addressed in the draft proposal. We concur. TA, as envisioned, would support and improve the environmental, technological, management, and financial capabilities of local and regional governments in the NIS, and needs to be directly integrated into the EGBP proposal. The proposal needs a clear outline of how the TA is to be managed, and whether and how this may be integrated with non-US sources.

A key aspect of TA will be the relationship of the parties involved. We believe that a public-private partnership would be a good approach. Critical government agencies including EPA, AID, and the Departments of State, Treasury, and Energy should work with in close cooperation with private sector experts (grantees and contractors) in implementing TA. We fully support tapping existing expertise such as that found in the Environmental Finance Center network created and supported by EPA's Office of the Chief Financial Officer, as well as looking to in country and other European sources for such expertise.

There may also be a timing element to TA. Another key to the success of TA will be its relationship or linkage to the EGBP itself. This must be clearly defined and established at the outset to avoid misunderstandings and protect the credibility of both the EGBP and the TA component. Lastly, we suggest you include in the final proposal a statement on how U.S. exports will be treated by the EGBP. In our discussions with government officials, we heard different views on this topic at different times. The relationship between U.S. exports and the EGBP needs to be clarified and resolved in the final proposal.

Final Observations

Three panelists, including myself, strongly believe that the "Environmental Bond Guaranty Program" concept is sound and that the Agency should forge ahead in its efforts to develop a final proposal. We also believe that a great deal of time could be wasted trying to answer each of the myriad of questions that can be raised about the program. Such an extended abstract debate would be a mistake. The need is clearly urgent. Many of the issues that will need to be addressed can only be answered "on the ground" in the NIS. With money in place for the program and real financial savings available to borrowers in the NIS, those questions will get answered more effectively and sooner than in a dragged out abstract debate. Naturally, a reasoned review to develop the program is essential, but given the multiple variables attached to the financing of just one environmental infrastructure project, any effort to try and anticipate and answer all the decision tree breaks on multiple projects would be futile.

A fourth panelist, Mr. Hinds, believes the EGBP concept holds promise, but has unresolved concerns. While he knows the concept is sound when applied to debt issued in a developed country, he is not yet convinced this will be the case in the NIS given the extreme volatility in their financial markets. He recommends that before developing any final proposal your Office work with industry experts, especially debt and equity analysts at the major financial houses,

to develop a more complete assessment of the viability of the concept. Such a process would parallel the scientific peer reviews utilized in the development of regulatory standards in other parts of the Agency. He thinks that it might also allow potential private partners to buy into the program at the initial stage, and play a key role in establishing the framework for the eventual privatization of the EBGp.

On behalf of the Environmental Financial Advisory Board, I want to thank you for the opportunity to assist your office in improving this exciting proposal. If the Board may be of any future assistance, please let me know. In closing, I want to recognize the other members of the Board's ad hoc workgroup -- Dr. Jim Tozzi, Peter Emerson, and Keith Hinds -- for their work in reviewing the proposal and developing this response.

Sincerely,

(signature)

Robert O. Lenna
Chair